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TAGS: ECON EFIN EINV ETRD LO
SUBJECT: SLOVAK ECONOMY CONTINUES TO GROW RAPIDLY, BUT SLOWER THAN EXPECTED

¶1. Summary: The Slovak economy continues to grow at a fast rate, reaching 8.9 percent real GDP growth in the first quarter of 2007, but did not attain the double-digit heights predicted by many economic analysts. Real wage growth increased 4.5 percent, which is higher than in the first quarter of 2006, but still lags behind productivity growth. The unemployment rate hit the historically low level of 8.33 percent, placing some pressure on wages. EU-norm inflation dipped to 1.5 percent, the lowest in Slovakia's history. End Summary.

BALANCED GDP GROWTH NOT PUSHING INFLATION

¶2. GDP increased by 2.3 percent points in the first quarter of 2007 (1Q07) in comparison with the first quarter of 2006 (1Q06), reaching 414.6 billion SKK (16 billion USD) total. In contrast to most of 2006, when economic growth was fueled primarily by imported stocks and supplies, growth was more clearly export-driven. Overall domestic demand rose 3.4 percent during the first quarter and private consumption maintained a rate of 6.3 percent annualized growth. Hence, there is no sign of significant inflationary pressure, but there is also limited space for monetary or fiscal flexibility in the near term.

¶3. The reduction in imports was to some degree a byproduct of an unexpected slowdown in the energy sector, which can be partially explained by the warm winter. Some of the import reduction is a statistical mirage, since a large percentage of this winter's energy-related imports were not counted by the Statistical Office during the first quarter, but will be accounted for in May 2007. In other sectors, the machinery / electronics / automotive industry grew by a robust 139.8 percent over 1Q06 due to increased production at the Kia and Peugeot Citreon plants. Projected real GDP growth for 2007 is 8.8 percent, thanks to the continuous high investment activity and related dynamic job growth.

SINGLE-DIGIT UNEMPLOYMENT

¶4. According to the Statistical Office (using data based on random telephone surveys), Slovakia's unemployment rate dropped by 2.9 percentage points in comparison to 1Q06, to 11.5 percent. This is Slovakia's lowest unemployment rate since 1997. Statistics provided by the Ministry of Labor, which are more in line with the U.S. methodology based on those actively seeking employment, indicated that unemployment dropped to a new historical low of 8.33 percent in May 2007. The unemployment rate decreased in 62 out of 79 districts in Slovakia, with the highest unemployment rate registered in Banska Bystrica region (14.32 percent) and Kosice region (13.82 percent). The number of long-term unemployed (more than two years) declined by 43,600 compared to 1Q06, but the lack of job skills among the numerous long-term unemployed still remains a serious impediment to continued high growth. Strong employment growth was propelled by

both domestic job creation and the continuing outflow of Slovaks to the EU. Despite positive developments in the labor market, unemployment in Slovakia still ranks among the highest in the EU.

REAL WAGES GROW, BUT LESS THAN PRODUCTIVITY

¶5. Real wages grew 4.5 percent in 1Q07, reaching average monthly salary of 18,511 SKK (app. 745 USD). This was slightly less than expected, but still a 7.1 percent increase in comparison with the same period last year. Productivity growth continues to exceed labor costs, which further suggests that inflationary pressures will remain limited in the short run. The biggest increase in nominal wages compared with 1Q06 was registered in health services (an increase of 12.6 percent), which is largely a byproduct of the settlement from last year's labor stoppages by public sector doctors and nurses.

NO DOMESTIC INFLATION RISK, BUT...

¶6. Inflation measured by the Ministry of Finance reached 2.4 percent but EU-norm inflation reached the historical minimum of 1.5 percent. Central bankers see no risks within the domestic economy that could create serious inflation. Governor Ivan Sramko of the National Bank of Slovakia has expressed concern, however, that inflation will pick up in June due to projected increasing fuel prices. According to Sramko, only exogenous risks like commodity prices and exchange rate fluctuations could potentially cause Slovakia to not meet its Maastricht criteria for inflation, but he stressed that this was unlikely. An internal European Central Bank (ECB) document, which was picked up by the media on June 26, notes that the ECB staff has concerns that Slovakia's low inflation rate may be short-lived. The memo questions whether the inflation performance is sustainable when

the favorable impact of nominal exchange rate appreciation against the Euro fades away. In response Sramko downplayed the report to the media noting that he had not heard any official concerns from the ECB over Slovakia's ability to meet the inflation criteria.

¶7. Prime Minister Robert Fico continues to balance adherence to Maastricht criteria with his desire to create new social programs. Last week Fico said, "I want to publicly state that, regardless of the strictness of the fiscal Maastricht criteria, the government has implemented and will implement...such a fiscal policy that will support economic growth...but also enable...solidarity."

VALLEE